Business Advisor
a resource for business owners
From the Law Office of Mary Hanson

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### About the BusinessAdvisor

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# ATTRACTING AND RETAINING A KEY EMPLOYEE

by Mary Hanson

One of the challenges for business owners is structuring compensation, benefits, and opportunities to attract or keep key employees. The challenge is identifying meaningful rewards for the employee to provide the greatest possible incentives to accept a job or stay with the employer while avoiding pitfalls for the employer.

A frequently discussed (and frequently overrated) incentive intended to attract or retain key employees is an ownership interest in the company. As I've written before, ownership does not necessarily provide any benefit to the employee and often burdens the company. The employee only benefits if the company is very profitable and compensates the employee beyond what the employee would otherwise receive, or if the company is sold for a good price or goes public. Additional compensation can be paid to the employee regardless of any stock ownership. The other hoped for benefits are far less likely to materialize. Even a sale of the business might never happen and might happen many years after the key employee's valuable service. In the meantime, the employee does not receive much benefit, if any, from the ownership of stock, while the company is burdened with corporate requirements related to having an additional shareholder.

To add insult to injury, an employee can end up owing taxes on profits in an S corporation or LLC that never made it to the employee's pocketbook. Profits reinvested in a growing business are often taxable to the shareholders or LLC members, whether any funds were distributed to them or not. Profits used to repay existing debt also boost taxable income whether or not any funds are distributed to shareholders.

Business owners are understandably reluctant to have employees hold stock in their businesses. If an employee shareholder leaves the business for any reason, the business owner not only hasn't succeeded in retaining the employee but also must figure out how to get the stock back. A dispute between two shareholders each owning fifty percent of the business can be remarkably similar to a divorce. A business owner who gave up a fifty percent interest to attract a key employee can be bitterly disappointed at how co-ownership works.

In many situations an employee can't legally hold an ownership interest in the business (e.g., a medical corporation, a law corporation, or an accountancy corporation) unless he or she holds the type of license required for ownership in the company. In such cases alternative incentives and compensation must be used.

This article is intended to describe some of the issues involved in using bonus compensation to incentivize a key employee to take a job or to stay in a job.

The challenge is finding an arrangement that serves to attract or retain a key employee without violating the law, bankrupting the business, discouraging hard work, ceding too much control to the employee, or jeopardizing the reputation or profitability of the



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business. Bonus compensation can offer a lot of benefit to both the employer and the employee.

Bonus compensation can be structured to effectively incentivize the effort of the employee to address objectives of the employer. A bonus structure can provide an immediate (or close to immediate) reward for the desired performance. Whether the company's goals are increased sales, increased profits, sales to a different market, or improvements in other aspects of the business operations, achievement of stated goals can be the basis of a bonus. As long as the performance can be measured, compensation can be tied to accomplishment of meaningful goals of the business. The flexibility of compensation (i.e., its ability to address a specific goal or various goals of a business) is very attractive. The flexibility of a bonus formula also enables the employer to avoid committing to compensation that might exceed profits.

An employer cannot offer compensation that might exceed the funds available unless the business owners are willing to "fund" any shortfall in order to compensate the key employee at that level. Any compensation arrangement should be so well reviewed and analyzed that the risk of paying compensation in excess of cash flow is well understood by the employer.

Bonus compensation can also mimic the benefits an employee would get with stock ownership. A portion of the profits can be paid to the key employee to mimic a distribution of profits to an S corporation shareholder or LLC member. In addition, or alternatively, the employer and the employee can enter into an agreement giving the key employee a set or calculated payout in the event the business is sold. Such promises are fraught with risk, but can be done. Careful planning and definition of the formulas are necessary for these methods of compensation, as they are for any formula-based compensation arrangement.

Matching the key employee's income with an owner's income can be tricky. Many owners take a set salary and also take a distribution of profits at the end of the year. That distribution is not tax deductible to the corporation. A payment of compensation to an employee is tax deductible and subject to payroll taxes. The payment of tax deductible compensation reduces the profits of the business and thus the potential profit distribution to the owner. Other challenges are that taxable profits may be boosted by cash-consuming actions such as repayment of debt and that profit distributions are discretionary.

Although most S corporation shareholders and LLC members are taxed on their percentage of taxable profits, distributions of profit, if any, are determined by the Board of Directors or the LLC Manager. If a business owner agrees to give a key employee a bonus in the same amount as the profits distributed to the owner, the owner may have the power to limit distributions and avoid a high bonus to the employee. If the owner agrees to give a bonus equivalent to the profit taxable to the owner, the number may be an unfortunate surprise for the owner. Any agreement on "matching" compensation between an owner getting a profit distribution and an employee getting a taxable bonus needs to be carefully planned. Even if the numbers (the distribution to the owner and the compensation to the employee) can be "evened up," the tax consequences are different and the amounts are arguably not equivalent.

An agreement to pay an employee in the event of a sale of the business has a


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number of drawbacks. There have been situations where an employee with a payout formula received more than the owners selling the business. It's difficult or impossible for business owners to anticipate the payment terms that might be proposed for any acquisition of their business. A simple formula may reward an employee with a high bonus while the owners receive a lower amount for sale of the business, based on adjustments or offsets.

In addition, any agreement for a bonus upon sale of a business must address what will be done if the employee does not stay with the company until the business is sold.

Both employers and employees may make inaccurate assumptions in structuring an employment and compensation arrangement. Here are some comments that may help identify problematic assumptions:

- Any reward or incentive - money, stock, employment benefits - may or may not incentivize an employee to perform as an employer wishes. A key benefit of incentive compensation is that, if structured well, it is only paid if the employee performs as required to earn the incentive compensation.
- An employer should not assume an employee wishes certain rewards unless the employee has expressed an interest in the particular compensation or benefit. Some compensation and benefits fail to generate the response desired by the employer because the employer's assumptions about the employee were wrong.
- When a new employee is recruited from the outside to "take the company to the next level" the parties need to have a detailed business plan and have a commitment to the plan. Assumptions based on past performance of the existing business have limited applicability.
- Even with a detailed business plan, projections for performance are typically based on assumptions that the existing business can successfully implement the new plan and that the new key employee has the ability to perform as needed to execute the new plan.
- If an existing key employee is asked to perform a new job function, the assumptions based on the employee's past performance may also have limited applicability.
- If incentives are offered to an existing employee to encourage different behavior or productivity by the employee, the arrangement must anticipate the real possibility that the employee will be unable or unwilling to make the desired changes.
- Both parties need to understand that assumptions about the employer's capabilities and the employee's capabilities may be wrong.
- Both the employer and the employee have to be realistic about what they are willing to do. Making a commitment that isn't met doesn't enhance the relationship needed to retain and get great performance from a key employee.
- The business must have the ability to replace the key employee if he or she cannot perform as anticipated. Possible loss of the employee – to another job opportunity, to death, injury, illness, personal problems, or any other cause – must be considered.
- Nothing a business owner or manager does can make a job candidate accept a job or make a key employee stay. No level of compensation or benefits can guarantee that an employee will take

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## Publisher's Note

While retaining an existing employee and attracting a new employee require the same analysis, the two situations are very different in a few key respects. If the key employee is a long-term employee, both the employer and the employee are familiar with the business and its culture, and exactly what the employee's role is. Of course, if the business is changing or the employee's role is changing, the situation is much more like that of hiring a new key employee. Both the employee and the employer may make erroneous assumptions about what the business can do and about the capability of the employee.

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a job, perform as required, or stay in the job.

- If the parties are planning to grow the business, the business plan must identify the source of funds. Effort and capability contributed by the key employee are likely to be inadequate if the necessary capital and people resources are not made available. Will the existing business provide funds, facilities, personnel, and other resources to support the new venture? The new key employee needs to know that the business will provide the resources needed to achieve the business goals. The business owner needs to be prepared to provide the resources, including funding, for the growth that is desired.

Some business owners may consider going into a new business venture with the key employee by starting a new entity co-owned by the parties. Many of the concerns described above apply. In addition, the business owner needs to consider other issues and assumptions. If the new business is really an off-shoot of the existing business, what happens if the relationship doesn't work out? If a large amount of capital is required, the parties need to discuss whether both the key employee and the existing business will provide funds. If the existing business contributes funding and the key employee contributes services, the contributions will probably never be equivalent.

A detailed business plan is even more critical for a new entity than for an employment arrangement. If the detailed plan reveals that the new business venture will be dependent upon the existing business for facilities, personnel, or other resources, the separate entity idea may not be a good one. BA

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